Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

July 15, 2013

## Final Basel III Capital Rule Yields Community Bank Wins and Losses

The final Basel III rules were not as hard on community banks as observers anticipated. On three key issues, regulators heeded community bank concerns and reversed course. Nevertheless, the industry didn't get everything it wanted. Here's a quick guide to the rule's most contentious issues and how regulators treated those issues in the final rule.

### TruPS

Many community banks crammed their portfolios with trust preferred securities (TruPS) – and with good reason. They were tax deductible and counted as Tier 1 capital – a double-benefit too delectable for many financial institutions to resist. Regulators soured on the instrument, however, when they found TruPS pools in so many failed banks and had such a hard time wringing concessions out of those pools. The proposed Basel III capital rules threatened to strip TruPS of their regulatory capital status for banks of all sizes, which would force community banks holding large stores of TruPS to raise a lot of capital or even consider selling.

In the final rule, small banks get their TruPS exemption. The

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## Final Basel III Capital Rule Gives Community Bankers Key Concessions, Keeps Higher Cap Standards

The Federal Reserve quietly signed off on finalized Basel III capital rules the other week and the OCC and FDIC quickly followed suit. And while the final rules do, as expected, saddle banks of all sizes with higher, more complicated capital standards, the final rule was not without several happy surprises for community bankers.

It's clear now that regulators were not deaf to community banker concerns, since the new rule includes several key revisions to parts of the rule that had generated much controversy among community bankers, including risk weightings for residential mortgages, the recording of AOCI in capital and the fate of trust preferred securities (TruPS) in community bank portfolios. And, what's more, smaller banks now have an extra year to comply with the rule.

Comptroller of the Currency Thomas Curry acknowledged the community bank-friendly changes last week. "With the new capital rule, the federal banking agencies are taking an important step to strengthen the banking system and protect it from future financial crises," said Curry. "I'm pleased that the new capital rule not only improves the quantity and quality of capital, but does so in a way that minimizes the burden on community banks

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## Opt-out or Not, Regulators Reserve Right to Force AOCI on Community Banks

Bank regulators listened when community bankers pointed to several key, potentially damaging provisions in the proposed Basel III capital rules. But not every rule revision is as clear as it seems. One point of contention with community bankers was the new capital rule's insistence that all banks recognize unrealized gains and losses in Accumulated Other Comprehensive Income (AOCI). And the new, final rule does give small banks a one-time opt out – a fact the regulators have trumpeted in public statements since the rule's release. But community bankers may not be so safe from AOCI after all – according to the fine print.

When regulators released the proposed capital rules, community bankers seized on the fact that the rule would force small banks to recognize all unrealized gains and losses in AOCI in common equity Tier 1 capital – a move that would inject a potentially high and perhaps damaging level of volatility in many bank's capital calculations.

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## Higher Cap Standards

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and federal savings associations."

Community bank advocacy efforts and arguments swayed regulators' thinking on several key issues and this amounts to a much better than expected outcome for community bankers, experts say. Nevertheless, some argue, the higher capital standards will not be easy to manage for community bankers in coming years.

"Community banks got some big wins here," says Jeff Reynolds, Managing Director, Darling Consulting Group, Newburyport, Mass. "This was a very decisive statement [the regulators made] that community banks are different – that they're not the problem that larger banks are."

"If you're a big bank – at $50B and up, at an advanced approaches bank – this new rule will be painful, but that's not the case for community bankers," adds Matt Jozwiak, VP and capital consultant, Griffin Financial Group, LLC, King of Prussia, Pa. "It's a good time to be a community bank."

### Mortgage risk weights

One of the key changes in the final rule involved mortgages and proposed risk weights. So many community bankers depend on residential mortgage lending as a core piece of their business strategy and that's why it was so significant that regulators reversed course on mortgage risk weights, Jozwiak says.

"They removed the potential to change the risk weights of residential mortgages," Jozwiak says. "That would have changed the culture of banks. Historically, mortgages carry a risk weight of 50%. The rule would have forced banks to look at real estate lending – the bread and butter of the industry – in terms of LTV and lien position. Community banks and even some regional banks have not collected this data. They don't have it. How would they calculate [the risk weights]? The rule would have slowed lending significantly. [The rule change] was a huge win."

### AOCI

The new rule also gives community bankers a one-time shot to opt out of the rules AOCI requirements, which would have injected a lot of extra, needless volatility into small bank capital calculations, as many bankers noted in comment letters.

Most smaller banks will likely take the opt-out and be happy with it, says Jonathan Hightower, a partner in the Atlanta office of Bryan Cave, LLP.

"The AOCI rule now has an opt-out rather than an outright exemption, so if a community bank so chooses, it can reflect gains and losses like a larger bank," he says. "It will be interesting to see how the mechanics develop, to see what percentage of community banks actually opt out, but my view is that most if not all should opt out. From a practical standpoint, these banks are not managing these accounts like trading accounts, which is how they'd be treated under the new rule."

(The AOCI opt-out may not be as sure as you think. See "Opt-out or Not," p. 1.)

### TruPS

Community bankers won't be able to buy into new TruPS pools and count as common equity Tier 1 capital, but, thanks to the Basel III capital rule reversal, bankers with TruPS already on the books won't have to worry about those investments being stripped of their capital status – and subsequently in having to raise capital to replace what capital they stood to lose.

Not every community bank holds significant amounts of TruPS, but enough do to make this a serious issue, Hightower says.

Community bankers did not get what they wanted on every issue. The new rule does, for example, keep in place the proposed rule's higher risk weights for higher risk CRE lending.

The rule will not likely kill off ADC lending, but it will contract it, Hightower argues. Neophyte developers, in particular, will have a much harder time with the new rules and that will mean lower overall demand for this form of lending.

"Established developers will put hard equity into projects," he says. "They'll still get attractive financing on projects that make sense. Where this rule will hit is in start-up developers who want to contribute to a piece of real estate as equity to the project. They can't do this anymore. They need to have the cash. And because the risk weighting has gone up 50%, the price will go up 50% and it will be much harder for them to compete in the development market."

## Capital standards

How necessary and apt are the new capital standards for community banks? Not everyone agrees.

"You don't get anything for nothing," says Kamal Mustafa, President of Invictus Consulting Group, New York.

The rule does "ease off on a lot of things community banks objected to, but the price they will pay for this easing is in higher capital requirements," he says.

"Basel III ratios are designed for large, international banks and have been misapplied to community bankers," Mustafa says. Regulators argue that nearly all community banks already meet the new capital standard, and while that is true today, that doesn't mean that the standard won't burden community bankers in the future, he adds.

"With regards to capital levels [impacting community banks now], the regulators are absolutely right – technically," he says. "But,

**"Banks will not need to be shut down. But look at what's happened to banks. They've had their loan value shrink because of low demand."**

the problem is, the regulators are concerned about short term sustainability. So yes, when regulatory capital levels go up, not that many banks will come in to it in a situation like in the recession. Banks will not need to be shut down. But look at what's happened to banks. They've had their loan value shrink because of low demand. There's increased competition, too. Net interest margins have been hammered and ROA has been hammered, too. So what happens now? They've jacked up requirements. "

Ultimately and eventually, bank margins will suffer even more, he argues.

"Regulators have achieved their objective. Very few banks face immediate shut-down, but all community banks are going to face a decline of ROE and restrictions on future growth – and all in an environment where rates will climb. There will be more pressure on bank spreads. There will be hemorrhaging in ROA and ROE and the inability to compete and the restrictions on growth will hammer the industry."

Actually, capital standards for banks of all sizes needed to come up and the final Basel III rule is a good start, counters Orlando Hanselman, Education Programs Director for Fiserv, Johnstown, Pa.

If regulators are concerned about the safety and soundness of all banks, they should resist the impulse to craft separate, lighter standards for smaller banks, Hanselman says. Regulators keeping new capital standards consistent across the range of bank asset size is a good start, he adds.

"It is true that size does, in a disaster situation, have a much higher impact on the FDIC insurance fund and the systemic economy, but I would hope that regulators are concerned with the safety and soundness not only of the system, but also in each institution as well," he says. "Each one has a constituency of dependent stakeholders, such as depositors, stakeholders, customers, and the local community. I would hope regulators have concerns about each."

The situation here with banks is akin to aviation, Hanselman adds. "A large jet crash creates more impact and devastation, more headlines than a smaller plane crash, but I would hope that the FAA, when it puts out safety and soundness regulations, would be equally concerned with the safety of a small crash."

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## Higher Cap Standards

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### Data

Capital management isn't the only major new implication of the finalized rules. The new capital standards will tax bank's data collection and management capabilities, too, says Peter Cherpack, director of credit risk technology, Ardmore Banking Advisors, Ardmore, Pa.

"Clearly, risk-based asset weighting will require additional calculations and tracking," he says. "High risk CRE loans, to meet certain criteria, will need to be tagged. Bankers will need to figure out not only how to tag them, but also where to store them. There are also changes here involving loans that have to meet certain LTV levels. That's information that's not often stored in the core. This will force more conversions of financial data typically kept in underlying systems and loan files. It needs to be transactional data now, so banks can track exposure to certain assets."

*Kamal Mustafa and Orlando Hanselman will be speaking at the BSSA Community Bank Integrated Risk Forum this November. See www.banksoundness.com for more details.* ■

## AOCI

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In a representative comment letter, Byron K. Bexley, Chairman and CEO of TexStar National Bank ($175 million) Universal City, Texas, criticized the rule's AOCI requirement.

"These gains or losses can be volatile depending on the current interest rate environment," he wrote. "This volatility would cause significant fluctuations in capital and do not represent a true piece of capital. If this becomes law, many community banks will likely evaluate holding U.S. Government and other securities in their investment portfolio. This will affect the profitability of those banks and will more importantly affect the ability of government entities to issue securities."

This argument seemed to sway regulators, who rewrote the rule to include an opt-out for smaller banks not interested in seeing their capital levels fluctuate.

"When we issued our proposals, one area that we highlighted for comment was whether the proposed treatment of Accumulated Other Comprehensive Income, or AOCI, would create unnecessary and harmful regulatory capital volatility for small banks and thrifts with holdings of available-for-sale (AFS) investment securities that are often in the form of Treasuries or other high-quality debt," said Thomas Curry, Comptroller of the Currency, on the release of the new rule. "We heard the concerns voiced by many small banks that the inclusion of unrealized gains and losses on AFS debt securities could result in large and volatile changes in capital levels that would be difficult and expensive for small banks to manage or hedge. The final rule gives these institutions an opportunity to opt out of this requirement, which I believe will prove very helpful for small institutions that buy securities as investments rather than as trading vehicles."

As it happens, the opt-out is not quite as firm as it may appear. The rule itself clearly states that regulators can rescind that opt-out whenever they want. Here is how the rule qualifies the opt-out:

"Notwithstanding the availability of the AOCI opt-out election under the final rule, the agencies have reserved the authority to require a banking organization to recognize all or some components of AOCI in regulatory capital if an agency determines it would be appropriate given a banking organization's risks under the agency's general reservation of authority under the final rule," the rule states. "The agencies will continue to expect each banking organization to maintain capital appropriate for its actual risk profile, regardless of whether it has made an AOCI opt-out election. Therefore, the agencies may determine that a banking organization with a large portfolio of AFS debt securities, or that is otherwise engaged in activities that expose it to high levels of interest-rate or other risks, should raise its common equity tier 1 capital level."

Are regulators saying what they seem to be saying? Yes, says Jonathan Hightower, a partner with Bryan Cave LLP, Atlanta. The rule offers small banks an opt-out, but that opt-out is hardly permanent. Regulators reserve the right to take it back if they see fit to do so.

"This certainly seems to be a back door, particularly for those institutions with relatively large securities portfolios as a result of weak loan demand," he says. "One would hope that authority would be seldom-used like the authority to downgrade an institution's PCA category based on safety and soundness concerns, but the authority is certainly there if needed."

Many community banks hold

investments for liquidity and do not want to have to recognize AOCI in regulatory capital, but if regulators see the bank as weak, if they think the bank is short on capital and needs access to more liquidity, they will insist that banks do recognize the AOCI in regulatory capital, says Kamal Mustafa, president of Invictus Consulting Group, New York.

"It's like that old story about banks – that if you have enough money already, they'll give you a loan," he says. "The regulators are turning it around. If you don't have enough capital, if they deem you don't have enough liquidity, they'll say you need to mark to market those investments held for liquidity. That's what they're saying here."

This is bad news for banks that find themselves hurting for capital.

"If you are really undercapitalized, you can't count on [those investments] as a cushion," he adds. "Banks on the borderline just can't depend on it." ■

## Wins and Losses

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rule will allow banks under $15B in assets to count currently held TruPS as Tier 1 capital.

"In consideration of community banking organizations' limited access to capital markets, and as permitted by section 171 of the Dodd-Frank Act, the draft final rule would not require a phase out of non-qualifying tier 1 capital instruments issued prior to May 19, 2010, for banking organizations with less than $15 billion in assets as of December 31, 2009, or that were organized in mutual form as of May 19, 2010," according to the Federal Reserve.

### AOCI

The proposed rules also would have required banks of all sizes to record all unrealized gains and losses in Accumulated Other Comprehensive Income (AOCI) in common equity Tier 1 capital – a move that would result in wild, roller-coaster swings in regulatory capital levels for community banks. Many commenters pointed this out and the regulators listened. In the final rule, smaller banks have a one-time opportunity to opt out of the AOCI recording requirement.

"The draft final rule would provide banking organizations other than advanced approaches banking

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**Finalized Basel III Capital and PCA Standards**

| | | Minimum Regulatory Capital Requirements | | Prompt Corrective Action Classifications | |
|---|---|---|---|---|---|
| | | Old | New | Old | New |
| Common Equity Tier 1 /Risk Weighted Assets (RWA) | Well Capitalized | | | | ≥6.5% |
| | Adequately Capitalized | N/A | 4.5% | n/a | ≥4.5% |
| | Undercapitalized | | | | <4.5% |
| | Significantly Undercapitalized | | | | <3% |
| Tier 1 Capital / RWAs | Well Capitalized | | | 6% | ≥8% |
| | Adequately Capitalized | 4% | 6% | 4% | ≥6% |
| | Undercapitalized | | | <4% | <6% |
| | Significantly Undercapitalized | | | <3% | <4% |
| Total Capital / RWAs | Well Capitalized | | | 10% | ≥10% |
| | Adequately Capitalized | 8% | 8% | 8% | ≥8% |
| | Undercapitalized | | | <8% | <8% |
| | Significantly Undercapitalized | | | <6% | <6% |
| Leverage Ratio | Well Capitalized | | | 5% | ≥5% |
| | Adequately Capitalized | ≥4% (or 3%) | ≥4% | 4% | ≥4% |
| | Undercapitalized | | | <4% | <4% |
| | Significantly Undercapitalized | | | <3% | <3% |
| Critically Undercapitalized | | | | Tangible equity to total assets ratio of ≤ 2% | Tangible equity to total assets ratio of ≤ 2% |

Source: Griffin Financial Group, LLC from Federal Reserve

## Wins and Losses

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organizations a one-time election to opt-out of the requirement to include most AOCI components in the calculation of common equity tier 1 capital and, in effect, retain the AOCI treatment under the current capital rules. The one-time election would be made on the first regulatory reporting period under the final rule and could only be changed in very limited circumstances, in order to discourage regulatory arbitrage," according to the Federal Reserve.

(That opt-out may not be as hard and fast as you think, however. See "Opt-out or Not," p. 1.)

### Risk Weightings for Mortgages

The proposed rule's risk weights for mortgages also drew a pile of comment letters from community bankers and small lender advocates. The risk weights were so high for what were, in many respects, stable loans, which would unnecessarily push many community lenders right out of the mortgage origination business, commenters said.

Did regulators agree? That's not clear. Regulators did not come out and say that that industry concerns over residential mortgage risk weights convinced them to scrap the weights entirely. Instead, regulators acknowledged the criticism and pointed to other new rules under consideration right now that aim to shore up mortgage lending (i.e., the QM rule). Nevertheless, community bankers do not need to worry about new residential mortgage risk weights from the Basel III capital rules. The final rule does not include the proposed risk weights for mortgages and instead uses the risk weights from the general, risk-based rules.

"In light of the new regulations designed to improve the quality of mortgage underwriting as well as continued uncertainty regarding the aggregate impact of pending mortgage-related rulemakings, the draft final rule does not include the proposed risk weights," the Federal Reserve notes.

### Deadlines

Big banks (i.e., those subject to the advanced approaches) have to comply by January 1, 2014. Smaller banks will not have to comply with the final rule until exactly one year later: January 1, 2015.

### Capital Buffers

Many commenters argued that the capital conservation buffer would unfairly burden smaller lenders, who have a harder time then their larger cousins when it comes to raising capital. Many of those same comment letters asked regulators to exempt small banks from the requirement entirely. As it happens, regulators opted not to exempt small banks from the requirement, noting that the buffer enhances the safety and stability of the financial system "by limiting capital distributions and discretionary bonus payments as the financial condition of a banking organization weakens."

The Federal Reserve notes that over 90% of BHCs with less than $10 billion in consolidated assets already have enough capital to meet the new minimum capital levels and the buffer.

In this case, the perceived regulatory benefits plus the relatively low perceived cost to most institutions trumped industry concern. "The benefits of applying the capital conservation buffer to all banking organizations outweigh the expected costs, and the final rule applies the capital conservation buffer, subject to transition provisions, to all banking organizations."

In limiting bonus and dividend activity for banks that fall below the buffer, the regulators hit bankers where it hurts, says Matt Jozwiak, VP and capital management consultant with Griffin Financial Group, King of Prussia, Pa.

"If you dip below the capital conservation buffer, there are restrictions that make it personal, bonus payments and dividends," he says. "That gets bankers' attention. It hits them personally, which was the point. Regulators want the CEO, executive officers and the board to really feel it."

### ADC Lending

The new rules create a new category for high-risk CRE, or the High Volatility Commercial Real Estate (HVCRE) loans and a new risk weight for loans that fit into that category: 150%.

Despite industry pushback, regulators preserved the higher weight in the final rule. ■